

THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

CHAPTER 1





CHAPTER 1 LEARNING OBJECTIVES

- 1-1 Describe auditing.
- 1-2 Distinguish between auditing and accounting.
- 1-3 Explain the importance of auditing in reducing information risk.
- 1-4 List the causes of information risk, and explain how this risk can be reduced.
- 1-5 Describe assurance services and distinguish audit services from other nonassurance services provided by CPAs.
- 1-6 Differentiate the three main types of audits.
- 1-7 Identify the primary types of auditors.
- 1-8 Describe the requirements for becoming a CPA.

OBJECTIVE 1-1
Describe auditing.



NATURE OF AUDITING

- **Auditing** is the **accumulation** and **evaluation** of **evidence** about information to determine and report on the degree of correspondence between the information and established criteria.
- Auditing should be done by a **competent, independent** *person*.

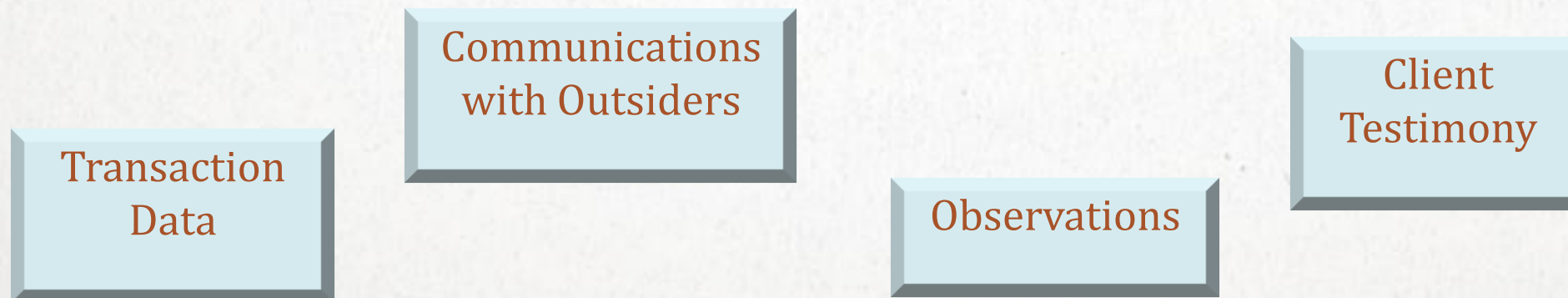
INFORMATION AND ESTABLISHED CRITERIA

To do an audit, there must be information in a verifiable form and some standards (criteria) by which the auditor can evaluate the information.

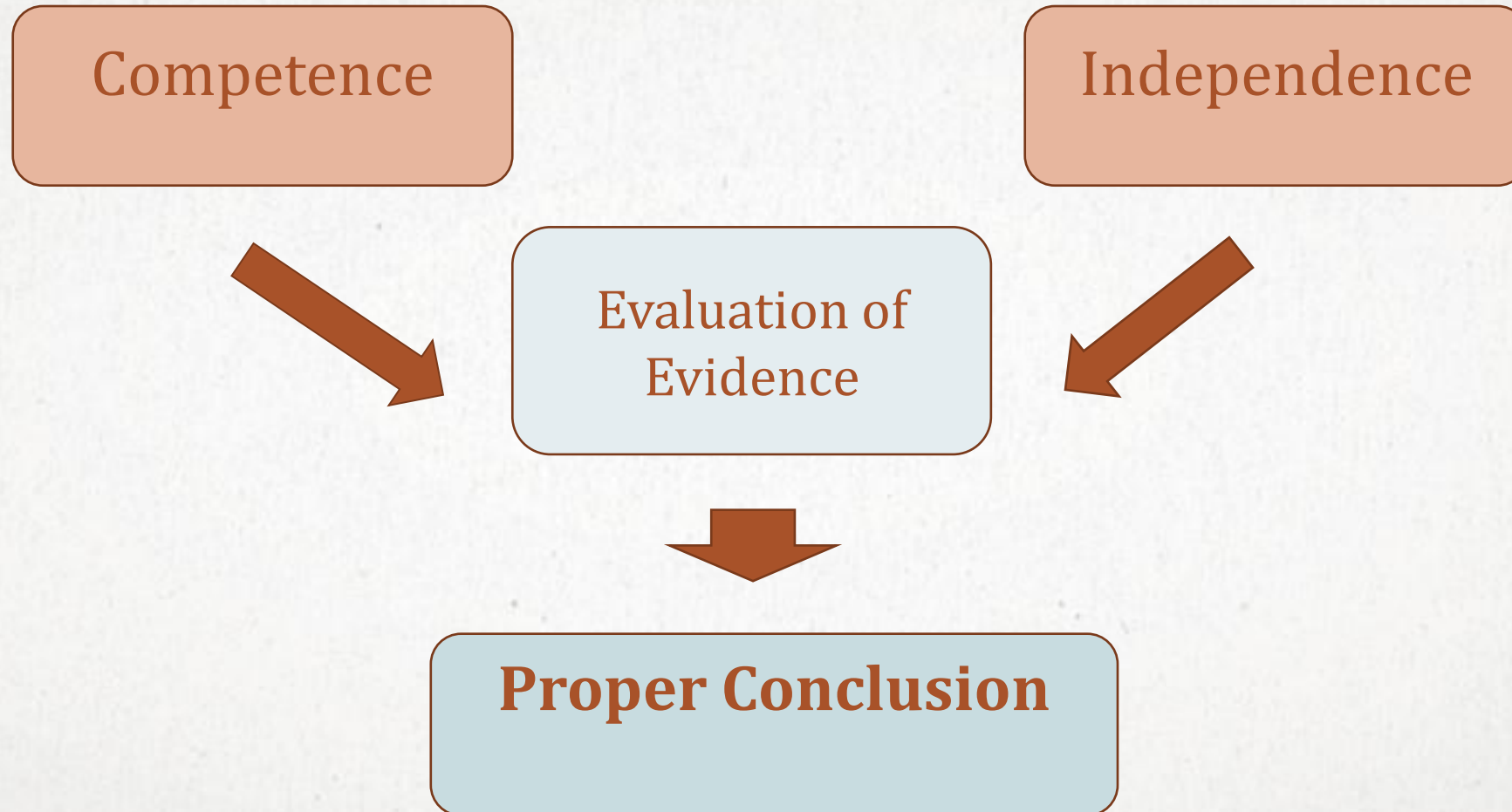


ACCUMULATING AND EVALUATING EVIDENCE

Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with established criteria.



COMPETENT, INDEPENDENT PERSON

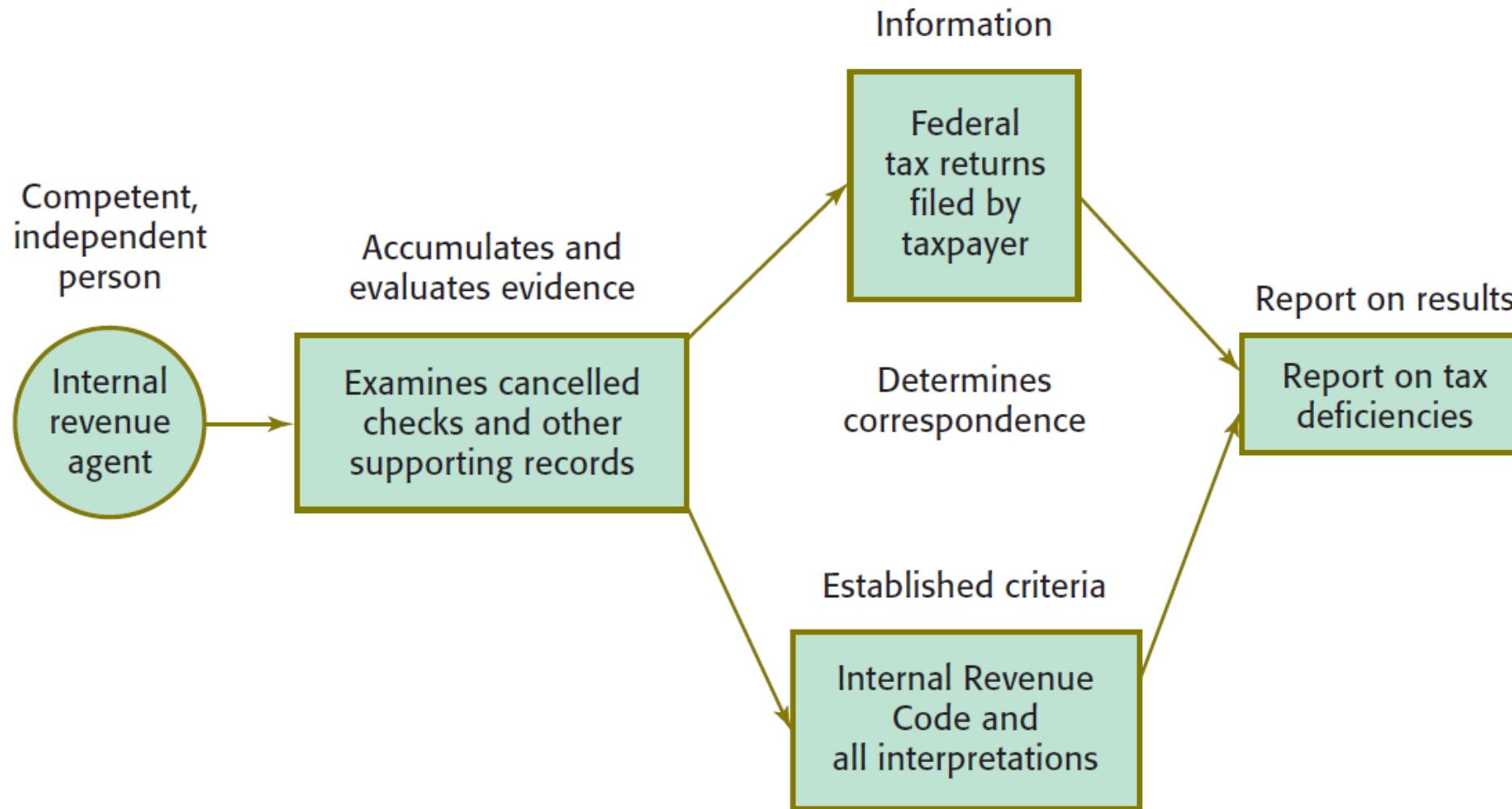


REPORTING

The final stage in the auditing process is preparing the *audit report*, which communicates the auditor's findings to users.

FIGURE 1-1

Audit of a Tax Return



OBJECTIVE 1-2
Distinguish between
auditing and accounting.



DISTINCTION BETWEEN AUDITING AND ACCOUNTING

- **Accounting** is the recording, classifying, and summarizing of economic events to **provide financial information** for **decision making**.
- **Auditors** focus on determining whether recorded information properly reflects the economic events that occurred during the accounting period.
- In addition to understanding accounting, auditors must possess **expertise** in the accumulation and interpretation of **audit evidence**.

OBJECTIVE 1-3
**Explain the importance of
auditing in reducing
information risk.**



ECONOMIC DEMAND FOR AUDITING

- **Information risk** reflects the possibility that the information upon which a business decision was made was inaccurate.
- **Auditing** of financial information reduces information risk to the users of financial information.

OBJECTIVE 1-4
List the causes of information risk, and explain how this risk can be reduced.



CAUSES OF INFORMATION RISK

- **Remoteness of information:** Decision makers do not have firsthand knowledge and must rely on information provided by others.
- **Biases and motives of the provider:** Information is provided by someone whose goals are inconsistent with those of the decision maker and may be biased.



CAUSES OF INFORMATION RISK (CONT.)

- **Voluminous data:** Higher volumes of transactions increase the likelihood of undetected errors.
- **Complex exchange transactions:** Transactions are increasingly complex and more difficult to record properly. Complex accounting standards are difficult to interpret and apply.

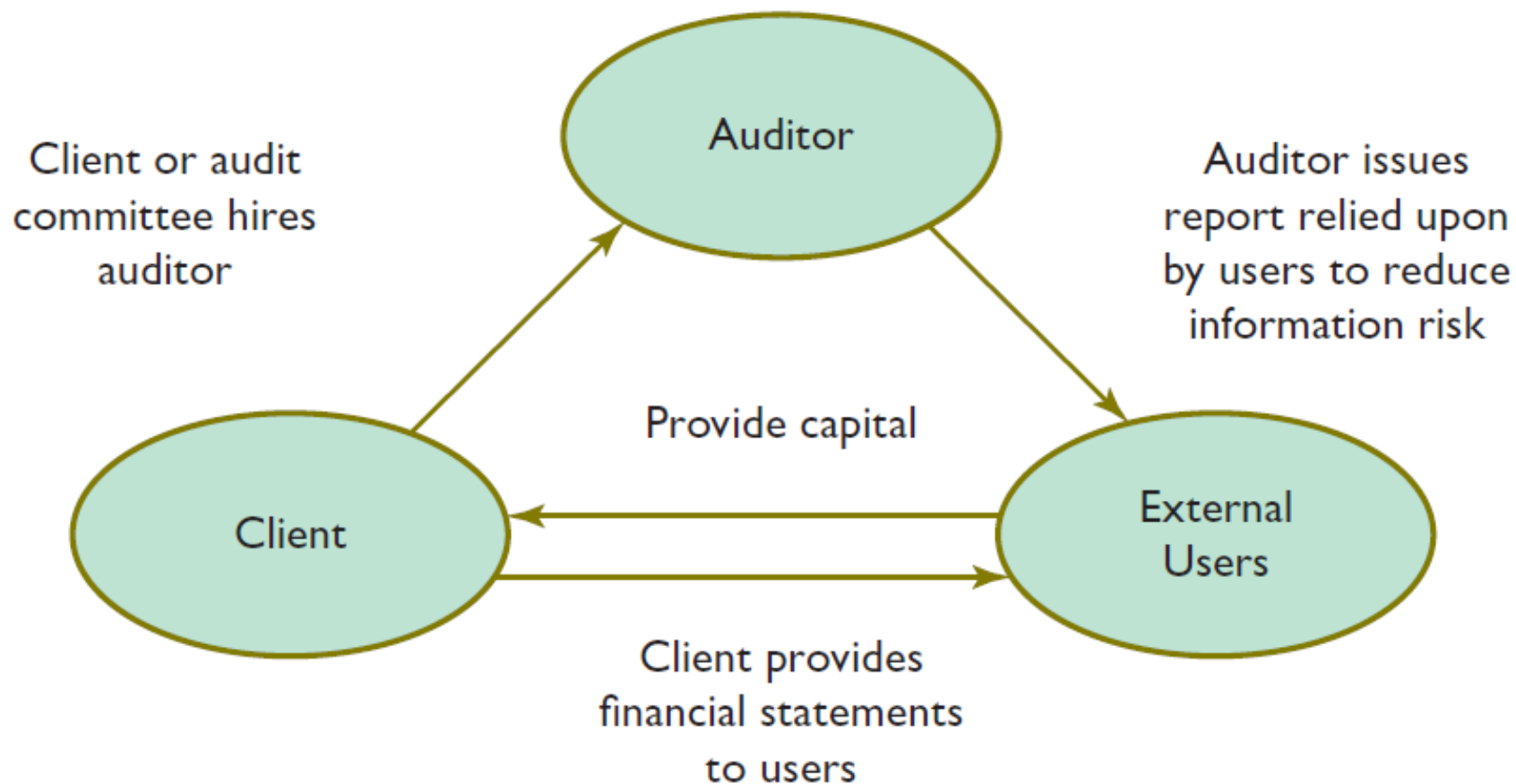


REDUCING INFORMATION RISK

- **User verifies information:** The user may go to the business to verify the information. This is often costly and impractical.
- **User shares information risk with management:** Management is responsible for providing reliable information, and may be held responsible in a lawsuit if inaccurate information is provided.
- **Audited financial statements are provided:** External auditors are engaged to provide assurance that the financial statements are reliable.

FIGURE I-2

Relationships Among Auditor, Client, and External Users



OBJECTIVE 1-5

Describe assurance services and distinguish audit services from other assurance and nonassurance services provided by CPAs.



ASSURANCE SERVICES

- An **assurance service** is an **independent professional service** that **improves** the **quality** of information for decision makers.
- Assurance services can be provided by CPAs or other professionals.
- Assurance services by CPAs have been common for years, especially regarding historical financial statement information.
- **Section 404** of the **Sarbanes-Oxley Act** now **requires assurance** regarding **internal controls** for larger public companies.

ATTESTATION SERVICES

An **attestation service** is a type of service in which the CPA issues a report about a subject matter or assertion that is made by another party.

Primary categories of attestation services include:

- Audits of historical financial statements
- Audits of internal control over financial reporting
- Reviews of historical financial statements
- Other attestation that may be applied to a broad range of subjects

OTHER ASSURANCE AND NONASSURANCE SERVICES

Other assurance services do not meet the definition of attestation services. A written report is not required, and it need not be about reliability or compliance.

Nonassurance services: CPA firms perform numerous other services that generally fall outside the scope of assurance services. Three specific examples are:

1. Accounting and bookkeeping services
2. Tax services
3. Management consulting services

TABLE I-1**Other Assurance Services Examples**

Other Assurance Services	Service Activities
Controls over and risks related to investments, including policies related to derivatives	Assess the processes in a company's investment practices to identify risks and to determine the effectiveness of those processes
Mystery shopping	Perform anonymous shopping to assess sales personnel dealings with customers and procedures they follow
Assess risks of accumulation, distribution, and storage of digital information	Assess security risks and related controls over electronic data, including the adequacy of backup and off-site storage
Fraud and illegal acts risk assessment	Develop fraud risk profiles, and assess the adequacy of company systems and policies in preventing and detecting fraud and illegal acts
Organic ingredients	Provide assurance on the amount of organic ingredients included in a company's products
Compliance with entertainment royalty agreements	Assess whether royalties paid to artists, authors, and others comply with royalty agreements
ISO 9000 certifications	Certify a company's compliance with ISO 9000 quality control standards, which help ensure company products are of high quality
Corporate responsibility and sustainability	Report on whether the information in a company's corporate responsibility report is consistent with company information and established reporting criteria

OBJECTIVE 1-6
**Differentiate the three main
types of audits.**



PRIMARY TYPES OF AUDITS PERFORMED BY CPA FIRMS

1. **Operational audit**—Evaluates the *efficiency* and *effectiveness* of any part of an organization's operating procedures and methods.
2. **Compliance audit**—Determines whether the auditee is following specific procedures, rules, or regulations set by some higher authority.
3. **Financial statement audit**—Determines whether the financial statements are stated in accordance with specific criteria. The criteria are normally U. S. GAAP or international accounting standards.

TABLE 1-2**Examples of the Three Types of Audits**

Type of Audit	Example	Information	Established Criteria	Available Evidence
Operational audit	Evaluate whether the computerized payroll processing for a Chinese subsidiary is operating efficiently and effectively	Number of payroll records processed in a month, costs of the department, and number of errors made	Company standards for efficiency and effectiveness in payroll department	Error reports, payroll records, and payroll processing costs
Compliance audit	Determine whether bank requirements for loan continuation have been met	Company records	Loan agreement provisions	Financial statements and calculations by the auditor
Financial statement audit	Annual audit of Boeing's financial statements	Boeing's financial statements	Generally accepted accounting principles	Documents, records, and outside sources of evidence

OBJECTIVE 1-7
**Identify the primary types of
auditors.**



IDENTIFY THE PRIMARY TYPES OF AUDITORS

The primary types of auditors:

- Certified public accounting firms
- Government accountability office auditors
- Internal revenue agents
- Internal auditors

CERTIFIED PUBLIC ACCOUNTING FIRMS

Responsible for auditing financial statements of all publicly traded companies, most other large companies, smaller companies, and noncommercial organizations

- Reflects the fact that auditors who express audit opinions must be licensed as Certified Public Accountants—CPAs
- Often also called *external auditors* or *independent auditors*

GOVERNMENT ACCOUNTABILITY OFFICE AUDITORS

An auditor working for the U. S. Government Accountability Office (GAO). The **GAO** reports solely to Congress.

- The GAO has many of the same responsibilities as CPA firms, though their primary responsibility is to perform the audit function for Congress.
- Authority for government agency spending is a matter of law, so there is considerable emphasis on compliance with laws and regulations.

INTERNAL REVENUE AGENTS

Responsible for enforcing **federal tax laws**

- Internal revenue agents' major responsibility is to audit tax returns for compliance with tax laws.
- The complexity of federal tax laws, including individual income tax, corporate income tax, estate tax, and gift tax, among others, requires considerable tax knowledge in addition to auditing skills.

INTERNAL AUDITORS

Internal auditors are employed by many organizations and function similarly to GAO auditors.

They most commonly perform compliance auditing, but may also be involved in operational audits.

To maintain independence, internal auditors often report to an audit committee of the board of directors.

OBJECTIVE 1-8
**Describe the requirements for
becoming a CPA.**



REQUIREMENTS FOR BECOMING A CPA

- Becoming a CPA is regulated by state law through the licensing boards of each state. **Three general requirements** must be met, though the specifics differ among states.
- The three requirements are:
 1. Education
 2. Uniform CPA examination
 3. Experience

FIGURE 1-3 **Three Requirements for Becoming a CPA**

**Educational
Requirement**

Normally, an undergraduate or graduate degree with a major in accounting, including a minimum number of accounting credits. Most states now require 150 semester credit hours (225 quarter credits) for licensure as a CPA. Some states require fewer credits before taking the examination but require 150 semester credits before receiving the CPA certificate.

**Uniform CPA
Examination Requirement**

Computer-based examination offered at various testing centers. Examination sections are as follows:

- *Auditing and Attestation (AUD)*
— 4 hours
- *Financial Accounting and Reporting (FAR)*
— 4 hours
- *Regulation (REG)*
— 3 hours
- *Business Environment and Concepts (BEC)*
— 3 hours

Some states also require a separate ethics examination.

**Experience
Requirement**

Varies widely from no experience to 2 years, including auditing. Some states include experience working for governmental units or in industry, including internal auditing.